State Investment Commission
Monthly Meeting Minutes
Tuesday, September 22nd, 2015
9:00 a.m.
Room 205, State House

The Monthly Meeting of the State Investment Commission (SIC) was called to order at 9:00 a.m., Wednesday, September 22, 2015 in Room 205, State House.

I. Roll Call of Members

The following members were present: Mr. J. Michael Costello, Mr. Thomas Fay, Ms. Faith LaSalle, Ms. Paula McNamara, Mr. Thomas Mullaney, Ms. Marcia Reback, Mr. Robert Benson, and Treasurer Seth Magaziner.

Also in attendance: Ms. Judy Chambers, Mr. John Burns, and Mr. Allan Emkin of Pension Consulting Alliance (PCA), general consultant; Mr. Mike Dorrell and Mr. Dan Schmitz of Stonepeak Infrastructure Fund, independent investment fund; Mr. Thomas Lynch and Mr. Steven Nesbitt of Cliffwater, alternative investment consultant; Mr. David Iden and Mr. Larry Brown from TIAA-CREF, defined contribution plan administrator; Ms. Susan Leach DeBlasio from Adler Pollock & Sheehan PC, legal counsel; Ms. Anne-Marie Fink, chief investment officer, and members of the Treasurer's staff.

Mr. Frank Karpinski arrived at 9:04 am. Ms. Marie Langlois was absent.
Treasurer Magaziner called the meeting to order at 9:00 a.m.

II. Approval of Minutes

On a motion by Ms. Reback and seconded by Ms. LaSalle, it was unanimously
VOTED: to approve the draft of the minutes of the July 21, 2015 meeting of the State Investment Commission.

III. Infrastructure Review & Stone Peak Recommendation

Ms. Judy Chambers gave a brief introduction to Stonepeak Infrastructure Fund II. She described the fund as a middle-market-focused, North American, core-plus/value-added fund.

Mr. Mike Dorrell detailed the fund's investment activities in infrastructure in the middle market in the United States and Canada. He elaborated that they invest in infrastructure, including solar facilities, energy pipeline assets, communications infrastructure assets, midstream energy, gas fired power generation, transport assets such as railroads, and telecommunications infrastructure such as cellphone towers. Additionally, they seek to provide a current cash coupon with growth potential and target around a 15% return.

Mr. Dorrell stated Stonepeak's focus is to secure better pricing due to the lack of competition for middle-market transactions between $50 million and $300 million; he stated that most infrastructure funds look at larger transactions. He attributed the fund's strong operational enhancement capability to the great track records of the fund's investment team.

A question was asked about the compensation structure of the fund's operating partners. Mr. Dorrell responded that there are four components of operating partner compensation: an annual, binding retainer; hourly fees during a transaction; a share of the options package for transactions in their area, and the opportunity to invest in portfolio companies on which they work.

A question was asked regarding what Mr. Dorrell perceived were the inherent risks facing the fund. Mr. Dorrell said that construction risk is their biggest concern from a risk management standpoint.

He added that the fund has consistently achieved returns above its target, but expects those returns will start to come down as the portfolio matures. Their strategy is still to create proprietary opportunities by helping high-quality developers shepherd their projects to the construction phase; Stonepeak does not take any financial risk until a project is at a stage where it can be built.

A question was asked regarding the relative equity stakes for developers. Mr. Dorrell said that developers' equity stakes depend on the specific project and the equity stake the fund takes.

Their main objective is still to be a lower risk investor and protect capital from potential downside risk. Mr. Dorrell said that all but one of their assets have long-term, take-or-pay contracts for all cash flows. The fund also has a relatively lower level of debt than other infrastructure funds and has locked in interest rates on their debt. When a project is under construction, the construction risk resides with the developer.

Mr. Dorrell explained the process for the firm's current holding in a desalination plant in Carlsbad, California as an example of how the fund invests.

Next Mr. Dorrell elaborated on the fund terms, stating they are generally more investor-friendly than their peer group's term. Stone Peak extended the low fees offered in its Fund I to this Fund II. The general partner will assess a 1.5% management fee and 20% carry, with a first close discount that reduces the carry to 15%. ERSRI can make the first close and achieve the more preferential terms. Stonepeak has a target fund size of $2.5 billion, which Mr. Dorrell expects they will exceed on the first close.

Mr. Dorrell said the fund has had success with Fund I due to the prudence and experience of their investment team and the plan with Fund II is to continue to invest in off-the-run, smaller transactions where there is less competition, creating a lower-risk portfolio that can achieve returns in the 15% range with a solid cash flow yield.

The board asked questions.

Mr. Dorrell and Mr. Schmitz left the room.

Ms. Judy Chambers gave an overview of the fund. She highlighted the strong returns thus far in its Fund I, though noted that only 3 of 8 acquisitions have been exited at this point.

Ms. Chambers also described some potential concerns with the fund. Stonepeak is doubling its fund size from Fund I to Fund II. They also have had staff turnover at the Vice President level and have pay off obligations to TIAA-CREF related to the initial seed money they invested in the fund.

The board asked questions.

Members of the commission stated comfort with the balance of risks and return potential, stating the fund was positioned well in the industry and the principals were still hungry despite past success. Ms. Chambers recommended an investment of $50,000,000 in the fund.

On a motion by Mr. Benson and seconded byMr. Fay, it was unanimously

VOTED: to invest $50 million in Stonepeak Infrastructure's Fund II

IV. Markets & Portfolio Update

Mr. Burns discussed general market trends and ERSRI's portfolio performance in August. He attributed the spike in global market volatility to uncertainty regarding current events in China, most specifically the Chinese equity market dip in August that wiped out $5 trillion in value. He brought up the accompanying increase in the VIX, which measures volatility in the S&P500, from 13 to 40 and the effect it had on investor confidence.

He described the continued slide in commodities and the slump in those countries whose economies are tied to commodities such as Canada. He also said that the widening of credit spreads showed investors were repricing risk. He explained the backdrop behind these trends were uncertainties regarding continued sluggish European growth, the potential that the Federal Reserve will raise U.S. interest rates, and the effects of the Greek and Puerto Rican debt crises.

Mr. Burns emphasized that the last few years have been a period of very low volatility with the ERSRI portfolio's volatility only at 4.8%. However, concerns of another 2008-like event precipitated a quick, dramatic repricing of risk in August. Separately, he noted that the Federal Reserve is less effective with interest rates at zero.

Despite the fears, Mr. Burns believes that the current landscape is less like the debt-related crisis of 2008 and more like a typical growth-fear correction. Considering historical context, a 10% decline in the U.S. equities market is not that unusual and the U.S. economy appears to be in good shape.

Regarding ERSRI's portfolio, equities markets have been weakening for a while with global equity off 8.3% in the last three months. Equity is the portfolio's biggest allocation and has been very volatile. The portfolio's public assets have all seen declines while the private assets have been relatively unaffected since they are priced on a lag.

Equity hedge funds fell but the decline was less than equities and in line with expectations. For the past three months, the equity hedge funds have helped reduce the volatility of the portfolio and have only dropped 1.5% compared to an 8.0% drop in the broader equity markets.

Overall the ERSRI portfolio is more diversified than in 2008 and the strategic allocation will help the portfolio navigate troubled markets. Specifically, core fixed income portfolio is designed for downside protection and is high quality with about 75% of the allocation in government issues. The real estate portfolio is also far more income-producing than in 2008.

The board asked questions about performance and positioning relative to other funds. Mr. Emkin noted the differences in ERSRI's characteristic, which results in more diversification and less risk tolerance than other funds. Treasurer Magaziner added that ERSRI is different from other pension funds with regard to having more of a global allocation, and cautioned against trying to time which countries will see growth.

Mr. Emkin provided analysis showing that various benchmarks, such as U.S. equity, private equity, and interest rate risk, are near historic highs. He cautioned to have modest return expectations in the future.

V. Briefing: Review of State CAFRs

Mr. Nesbitt presented findings from his annual review comparing the financial performance and asset allocations of state pension plans. Due to lags in reporting, the review covered returns through the end of June 30, 2014.

The findings of the report showed that, in a distribution of total fund performance over a 10 year period through June 30th, 2014, ERSRI's performance of 7.0% was near the median for state pensions. The average return over the period for state pensions was 7.3%, fairly close to the actuarial targeted return.

Treasurer Magaziner pointed out limitations in drawing conclusions from these numbers because some state pensions report returns net of fees while others reported returns gross of fees. Mr. Nesbitt said his numbers do not correct for these differences in reporting.

Mr. Nesbitt noted the large dispersion among state pensions' returns, which suggests that state pension managers can have a meaningful impact on pension fund financial performance.

The report also highlighted trends in asset allocation, showing that the major impact of the 2008 crisis was a reduction in both U.S. and foreign equities and an increased allocation to alternative investments. Since 2011, there has been a continued, slow increase in alternative allocations coupled with a slow decrease in equity and fixed-income allocations.

In terms of composition of the alternatives for pension funds, private equity is the most popular asset class. He went on to review the returns for the 10 year period by asset class. The lowest preforming asset class was US bonds. With limited data, Mr. Nesbitt said those funds that have redeemed from hedge funds generally had poor performance.

In conclusion, he stressed the importance of sophisticated management of the portfolio and encouraged the commission to follow the current asset allocation strategy, which combines low fees in traditional asset class with a strong commitment to alternative asset classes to improve risk-adjusted returns.
The board asked questions.

VI. Private Equity Quarterly Review

Mr. Lynch gave a review of the private equity portfolio. Long-term performance has been good and the more recent performance has been mediocre due to a lack of commitments to private equity in 2009 and 2010, two particularly strong vintage years. While exposure to the older part of the portfolio has been doing well, it will not drive performance over the next couple years.
The long-term returns has been 13.7% with a value of 1.5 times.
He reviewed private equity cash flow for the first half of the calendar year. It continues to be a robust year for distributions, but a slower period for investing, which indicates that asset valuations are high.
He reviewed ERSRI's commitments and cash flows. Cash flows remain strong.
He reviewed some of the positive and negative drivers of performance, in particular noting that adding Asia manager has diversified the allocation. He noted that managers have continued to perform well. In terms of long-term performance, the private equity portfolio is exceeding public equities.
He added that the portfolio is well-diversified by exposure.

VII. Hedge Fund Fiscal Year-End Review & Claren Road Recommendation

Mr. Lynch reviewed the objectives and compositions of the equity hedge-fund portfolio and the real-return hedge-fund portfolio. Both portfolios are meeting their objectives.
He went on to show the performance of the hedge fund portfolios. Since inception, the equity hedge fund portfolio has produced a return of 7.63% with a risk level of 4.08%. The portfolio has also outperformed the benchmark by 2.44% since inception.
The real return portfolio produced a return 4.9% with a risk of 2.74%. The portfolio exceeded the benchmark by almost 5%.
Mr. Lynch talked about the alpha, beta and risk free rate of returns for each of the portfolios. The equity hedge fund portfolio does not have a lot of beta exposure but has gotten reasonable absolute returns from alpha and the same is true for the real-return portfolio.
The portfolios have been producing less risk relative to the index. Both have produced better returns but also less risk since inception.
Next, Mr. Lynch discussed a recommendation to redeem from Claren Road credit fund in the real return portfolio. As of August 31, ERSRI has $43,000,000 invested with them. The strategy for Claren Road was to be defensive in negative credit environments. He noted Cliffwater placed the fund on its watch list earlier this year. He added Cliffwater recently moved to recommend redeption, because Cliffwater lost confidence in the fund's overall risk control and were concerned by the fund's underperformance. Claren Road also has significant redemptions that Cliffwater believes will disrupt the fund's overall business. For these reasons Mr. Lynch recommended redemption.
The board asked questions and discussed.

On a motion by Ms. Reback and seconded by Mr. Costello, it was unanimously
VOTED: to redeem the investment in Claren Road credit fund.

VIII. Defined Contribution Plan Quarterly Review

Mr. Iden reviewed the demographics of the plan. The plan has $406 million in total assets, with the bulk in the Vanguard lifecycle funds. TIAA noted a recent uptick with online log-ins and online advise sessions. Mr. Iden went on to review the FICA alternative place. The plan has $574,000 in total assets.
Next Mr. Brown reviewed the plan's performance, which was generally in line with expectations given the concentration in index funds. He said the regulations governing money markets will change as of October 16, and Vanguard has announced that its fund will remain as a retail money market fund, so it is not impacted by gate provisions.
Mr. Brown reviewed the returns for each asset category. He said all returns fall in line with their relative benchmarks. For the amount of assets in the respective categories the plan has the lowest expense ratio. He said the Vanguard target-date funds will move to a lower fee at the end of the year

IX. Proxy Advisor RFP Recommendation

Ms. Fink said that with the move of the assets to the factor tilt portfolio, ERSRI will now been in a separately managed account. With this comes the obligation to vote proxies.
She asked the commission for a vote to issue an RFP for a proxy advisor. The advisor will organize and execute on the thousands of votes a year and will help to craft a policy.

On a motion by Ms. Reback and seconded by Ms. LaSalle, it was unanimously
VOTED: to issue an RFP for a proxy advisor.

X. Legal Counsel Report

There was no legal counsel report.

XI. Chief Investment Officer Report

Ms. Fink gave an update on current outstanding RFPs. The review committee for the 529 plan administrator RFP has narrowed the respondents to a short list and is conducting site visits. They are striving for a recommendation at the October or November meeting. The focus will be on achieving the best outcome, rather than rushing the process.
The foreign compliance advisor RFP has gotten responses and she expected to bring a recommendation to the October meeting.
She said the transition to the factor tilt portfolio is proceeding on pace and she expected to have the first $250 million invested by October 1st.

XII. Treasurer's General Comments

Treasurer Magaziner thanked the board for their focus and service.

There being no other business to come before the Board, on a motion by Ms. Reback and seconded by Mr. Fay the meeting adjourned at 11:55 a.m.

Respectfully submitted,

Seth Magaziner,
General Treasurer